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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of Federal-State Joint Board )  
on Universal Service (Report to Congress) )

CC Docket No. 96-45

**COMMENTS OF AIRTOUCH COMMUNICATIONS, INC.  
ON REPORT TO CONGRESS**

Kathleen Q. Abernathy  
David A. Gross  
**AirTouch Communications, Inc.**  
1818 N Street, N.W.  
Washington, D.C. 20036  
(202) 293-3800

Charles D. Cosson  
Pamela J. Riley  
**AirTouch Communications, Inc.**  
One California Street, 29th Floor  
San Francisco, CA 94111  
(415) 658-2000

Its Attorneys

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## SUMMARY

The 1998 appropriations legislation for the Departments of Commerce, Justice, and State<sup>1</sup> directs the Commission to submit to Congress a report on the Commission's implementation of the universal service provisions of the Communications Act of 1934, as amended by the Telecommunications Act of 1996 (1996 Act).<sup>2</sup> While the Commission has made some commendable progress toward reforming universal service, it is not enough.

The universal service provisions of the 1996 Act, and the Commission's approach, influenced by the Joint Board's *Recommended Decision*,<sup>3</sup> to implementing them, fail to acknowledge the fundamental change in telecommunications regulation Congress intended. Existing universal service mechanisms and regulations fall far short of what is needed to serve the public interest. To the extent that legislative revision is needed to create a far more effective and efficient method of ensuring affordable access to telecommunications, the Commission should ask Congress to revise Section 254 consistent with the basic economic principles explained herein.

"Universal service," as a broad concept, is ostensibly about fulfilling the statutory objectives of providing consumers—including those in rural areas or those with low incomes—with access to telecommunications services, thereby binding our nation together through the telecommunications network.<sup>4</sup> Universal service policies can maximize the usefulness of telecommunications networks by ensuring that access is affordable,<sup>5</sup> but must

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<sup>1</sup> H.R. 2267.

<sup>2</sup> 47 U.S.C. § 151 et seq.

<sup>3</sup> Universal Service Recommended Decision (*Recommended Decision*), 12 FCC Rcd 87, 560.

<sup>4</sup> See, e.g., 47 U.S.C. § 254(b).

<sup>5</sup> "In the Matter of Federal-State Joint Board on Universal Service," CC Docket No. 96-45, Report and Order, FCC 97-157 (May 8, 1997) ("*Universal Service Order*"), para. 8.

operate as part of a “pro-competitive, de-regulatory national policy framework” that encourages private investment. This is a legitimate goal. But to the extent that the Commission’s regulations are intended to fulfill this goal, they are fundamentally flawed in their approach.

A large part of what the Commission is undertaking in its universal service proceeding, along with related proceedings in access charge reform and separations reform, is an attempt to preserve a decades-old system of settlements, subsidies, and service charges that was created in a monopoly environment. Although the Bell System was divested in 1984, its infra-company system of settlements and the NARUC-created system of separations were never really dismantled. At best, they were adjusted and re-labeled in an attempt to deal with the advent of long-distance competition. Now, with the advent of local competition, those “universal service” mechanisms must be dismantled once and for all. Attempts to preserve the old system, or even the end results of the old system through different means, are inconsistent with Congressional intent to introduce local competition and are doomed to failure.

Unfortunately, many of the Commission’s current universal service decisions reflect the old approach. The pricing distortions created by implicit subsidies formerly provided through cost allocations or rate disparities are now simply pricing distortions created by explicit subsidies borne by all telecommunications carriers (although not all users of the network, most notably Internet service providers). In other respects, the Commission is implementing new programs designed to benefit schools, libraries, and rural health care providers through a process similar to that used to subsidize rural telephone companies: it is both heavy with bureaucracy and light on specific expenditure controls.

Both the Commission’s existing regulations and its proposed “reforms” will waste billions of dollars annually while failing to ensure that those Americans most in need of assistance with access to telecommunications services receive it. Telecommunications

consumers and providers pay billions of dollars toward universal service each year, yet low income and minority segments of the population continue to have low penetration rates.

The reasons for the poor performance of universal service policies are clear:

- Under Commission policies, universal service subsidies are not targeted toward those subscribers and services that genuinely need support. The results are inflated program costs and diminished effectiveness. The Commission's subsidization of inside connections for schools and libraries, as well as its decision to subsidize second residential lines and single-line businesses, further increase the cost of these programs without generating social benefits commensurate with the costs.
- The Commission funds universal service by taxing an overly narrow base: generally, interstate telecommunications services. This approach distorts economic efficiency by artificially suppressing demand for the taxed services and it harms the very consumers the policies are ostensibly designed to help. Moreover, as empirical studies have shown, the demand for local telephone access is dependent on toll rates, and thus these taxes largely cancel out any beneficial effects on penetration due to the reduction in the prices of local access. Further, these problems are made worse by the Commission's decisions to exempt Internet service providers (ISPs) and incumbent local exchange carriers (LECs) from contributing to universal service funding. Both decisions place greater burdens on the consumers and providers of other services.
- Current policies make it difficult for carriers other than incumbent LECs to compete in the provision of local exchange services. Thus, consumers are denied the benefits of competition.

Congress intended that consumers be the ultimate beneficiaries of universal service policies. A majority of the Joint Board explicitly emphasized in separate statements that excessive universal service programs harm consumers because consumers are the ultimate financial contributors to any universal service program.<sup>6</sup> In order to minimize the expense on consumers and provide them with the most direct benefits, universal service programs should be designed as efficiently as possible.

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<sup>6</sup> See *Recommended Decision*, 12 FCC Rcd 87, 560 (separate statement of FCC Commissioner Rachelle B. Chong); *Id.*, 12 FCC Rcd at 568 (separate statement of Florida PSC Commissioner Julia Johnson and Washington UTC Commissioner Sharon Nelson); *Id.*, 12 FCC Rcd at 577-78 (separate statement of South Dakota PUC Commissioner Laska Shoenfelder).

The Commission, working with Congress, should move to implement the following policies:

- Target subsidies to those who need them. The subsidy that a household receives should be based on its income and the cost of telephone service that it faces. Second residential lines and single-line businesses should not be subsidized. Subsidies to schools and libraries should be limited to only low-income communities.
- Implement a vouchers program in which the amount that a household receives varies according to the criteria discussed above. Vouchers will ensure that subsidies are portable across carriers, so that local exchange competition can have a chance to develop. The use of vouchers will also allow markets forces and consumers' pursuit of their own welfare to guide the choice of universal service provider, rather than having to rely on a complex and inevitably inflexible set of government regulations and eligibility requirements.
- Ideally, Congress would fund universal service out of broad-based taxes, such as the federal income tax. In the absence of this funding option, the Commission should collect universal service taxes through lump-sum charges collected on a per-line basis. These taxes could be graduated according to the same criteria used to target subsidies (*e.g.*, low-income consumers would be exempt from the taxes). The efficiency losses to the American economy resulting from this tax system would be a small fraction of those generated by the Commission's current and planned policies.

Before the

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In the Matter of Federal-State Joint Board                    ) CC Docket No. 96-45  
on Universal Service (Report to Congress)                    )

## COMMENTS OF AIRTOUCH COMMUNICATIONS, INC. ON REPORT TO CONGRESS

AirTouch Communications, Inc. (AirTouch)<sup>7</sup> hereby submits the following comments in the above-captioned proceeding.<sup>8</sup>

### I. INTRODUCTION

The 1998 appropriations legislation for the Departments of Commerce, Justice, and State directs the Commission to review the implementation of the universal service provisions of the 1996 Act and to submit a report to Congress no later than April 10, 1998. The report is to provide a detailed description of the extent to which the Commission's interpretations in five areas are consistent with the plain language of the 1996 Act:

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<sup>7</sup> AirTouch is a wireless communications company with interests in cellular, paging, personal communications services, satellite and other operations.

<sup>8</sup> "Common Carrier Bureau Seeks Comment for Report to Congress on Universal Service Under the Telecommunications Act of 1996," Public Notice DA 98-2, (released January 5, 1998) (*Public Notice*).

1. the definitions of "information service," "local exchange carrier," "telecommunications," "telecommunications service," "telecommunications carrier," and "telephone exchange service" in section 3 of the Act, and the impact of the interpretation of those definitions on the provision of universal service to consumers in all areas of the Nation;
2. the application of those definitions to mixed or hybrid services and the impact of such application on universal service, and the consistency of the Commission's application of those definitions, including with respect to Internet access for educational providers, libraries, and rural health care providers under section 254(h) of the Act;
3. who is required to contribute to universal service under section 254(d) of the Act and related existing Federal universal service support mechanisms, and of any exemption of providers or exclusion of any service that includes telecommunications from such requirement or support mechanisms;
4. who is eligible under sections 254(e), 254(h)(1), and 254(h)(2) of the Act to receive specific Federal universal service support for the provision of universal service, and the consistency with which the Commission has interpreted each of those provisions of section 254; and
5. the Commission's decisions regarding the percentage of universal service support provided by Federal mechanisms and the revenue base from which such support is derived.

In the *Public Notice*, the Commission requested public comments to assist it in the preparation of this report. AirTouch provides these comments in response to the Commission's request.

## **II. BACKGROUND**

In order to evaluate the Commission's implementation of the universal service provisions of the 1996 Act, it is essential to understand the overall state of universal service policy. In many ways, United States telephone penetration is a tremendous success story. Overall penetration stood at almost 94 percent in March 1997,<sup>9</sup> one of the highest in the

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<sup>9</sup> *Monitoring Report*, CC Docket No. 87-339, May 1997, at 14.

world. It is not an exaggeration to say that the public switched telephone network helps unite our nation.

It would be a mistake, however, to take this high penetration rate as a sign that the Commission's universal service policies are working well and serve the public interest. There are several important reasons why such a conclusion would be unwarranted. First, much of the credit for the high rate of penetration does not go to state and federal universal service policies. Instead, the credit goes to the success of the U.S. economy in general and the operation of telecommunications markets in particular. The United States has long had one of the least regulated telecommunications sectors in the world, and this approach has consistently promoted the growth and innovation that result in high levels of penetration. The emergence of competition in the provision of local telephone service can be expected to increase penetration further.<sup>10</sup>

It also is important to recognize that Commission and state universal service programs are not the only distributors of subsidy funds. For example, the Rural Utilities Service (RUS) makes loans to rural telephone companies and cooperatives to provide service.<sup>11</sup> The RUS also makes grants and loans for rural distance learning and telemedicine projects. Similarly,

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<sup>10</sup> Unfortunately, as discussed below, the Commission's universal service policies may be an obstacle to the development of local exchange competition.

<sup>11</sup> See <http://www.usda.gov/rus/telephone/telephon.htm>.

the Technology Challenge Literacy fund is providing \$2 billion over five years to help schools connect to the Internet.<sup>12</sup>

Even if one concludes that market forces supplemented by non-Commission governmental programs will not sufficiently promote universal service, the Commission's current policy approach is critically flawed. Economic analysis has consistently demonstrated that the Commission's universal service policy is largely at war with itself. It taxes the very consumers that it subsidizes. And it does so in a way that largely cancels out any net effects on overall penetration rates while at the same time suppressing the demand for toll and wireless telecommunications services. These perverse effects come about as the result of central problems in both: (a) the means of distributing subsidies, and (b) the means of collecting the money to fund them.

#### **A. The Distribution of Universal Service Subsidies**

The Commission and the Joint Board repeatedly assert that their policy approach will advance universal service by avoiding increases in rates for the local telephone service of incumbent LECs.<sup>13</sup> Yet, the Commission's *Order* found, unsurprisingly, that few problems with access to telecommunications services stem from rates for these services.<sup>14</sup> Rather, consumers' inability to afford service or their disconnection from the network is caused by the

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<sup>12</sup> December 19, 1997 letter to William E. Kennard, FCC Chairman, from Senators John McCain and Tom Bliley at 4.

<sup>13</sup> See, e.g., *Universal Service Order* at para. 2 ; *Id.*, Separate Statement of Reed Hundt.

<sup>14</sup> See *Universal Service Order* at para. 2.

consumer's inability to pay high usage-based charges for interstate services.<sup>15</sup> The finding that local service rates have relatively little impact on consumer decisions whether to purchase access to the public switched telephone network is consistent with the empirical studies of consumer demand for telephone access.<sup>16</sup> The Commission should eliminate this policy approach that continues to direct money where it will have little effect on penetration levels or other consumer benefits.

There is second central flaw in the way the Commission distributes support funds. Rather than targeting consumers most in need of assistance, the Commission has adopted a scattershot approach. This approach leads to two serious problems. First, as discussed in greater detail below, these policies subsidize many people who would otherwise subscribe to the public switched network even in the absence of such subsidies. By subsidizing those who do not need the help, current universal service policies unfairly and wastefully tax other telecommunications services consumers and providers.

The second problem with the untargeted approach is that it fails to provide additional assistance to those who most need it. Data analyzed by the Commission demonstrate that low income, unemployed, and minority individuals have far lower penetration levels than do other

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<sup>15</sup> *Universal Service Order* at para. 390. Rather than making toll services more affordable, the Commission adopted a rule prohibiting disconnection of local services for failure to pay toll charges. This, of course, amounts to an additional cost imposed on carriers which will be passed on to other paying customers in one form or another.

<sup>16</sup> See Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *American Economic Review* 83:2, (1993), at 178-184.

households. For example, in March 1997 for approximately nine percent of households of Hispanic origin with incomes between \$20,000 and \$24,999 there was neither a telephone in their house/apartment nor was there a telephone elsewhere at which people in that household could be called.<sup>17</sup> For households of Hispanic origin with incomes between \$15,000 and \$19,999, the corresponding figure rises to over 15 percent. For approximately seven percent of black households with incomes between \$15,000 and \$19,999 there was no telephone available at which people in that household could be called.<sup>18</sup>

These figures are not isolated examples. In its most recent analysis of telephone penetration, the Commission reported the following findings:

“In November 1997, the telephone subscribership penetration rate was 77.2% for households with annual incomes below \$5,000, while the rate for households with incomes between \$60,000 and \$74,999 was 98.9%. ... Households headed by whites had a penetration rate of 95.0%, while those headed by blacks had a rate of 86.6% and those headed by Hispanics had a rate of 86.8%. By age, penetration rates ranged from 85.7% for households headed by a person under 25 to 96.7% for households headed by a person between 65 and 69. Households with 6 or more people had a penetration rate of 91.1%, compared to a rate of 95.0% for households with 4 or 5 people. The penetration rate for unemployed adults was 86.8%, while the rate for employed adults was 95.4%.”<sup>19</sup>

The data are clear: current universal service policies fail significant segments of society. It would be tremendously expensive and wasteful, however, to attempt to increase

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<sup>17</sup> *Monitoring Report*, Table 1.5.

<sup>18</sup> *Monitoring Report*, Table 1.5. As the *Monitoring Report* shows, the examples in the text is far from unique.

<sup>19</sup> “FCC Releases New Telephone Subscribership Report,” FCC Press Release (rel. January 21, 1998) at 1.

the penetration levels of these disadvantaged groups by further increasing overall, untargeted subsidies. Most of the incremental subsidies would go to the 94 percent of the households who already are connected to the public switched telephone network at current subsidy levels. Instead what is needed is a targeted approach that identifies those who are in need of subsidies and ensures that these people—and no others—receive subsidies. There are two steps that must be taken to implement meaningful and effective targeting.

The first step in reforming scattershot universal service policies is to target households, not carriers or geographic service areas. The goal of these policies is to promote subscribership, and the best and most direct way to do that is to assist people in subscribing. Policies that subsidize carriers and geographic areas without regard to the characteristics of subscribers result in subsidy flows to subscribers who are in no need of them.

The FCC's own statistics show no meaningful correlation between lack of telephone subscribership and the question of whether a state is urban or rural. For example, the District of Columbia which is almost entirely urban has an annual average percentage of only 90.8%, while a relatively rural state such as Utah has a penetration of 96.9%.<sup>20</sup> Pennsylvania and Nebraska, the states with the highest level of penetration (97.1%)<sup>21</sup> are largely rural.<sup>22</sup>

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<sup>20</sup> "Report on Telephone Subscribership" (rel. January 21, 1998) at Table 4.

<sup>21</sup> *Id.*, Table 4.

<sup>22</sup> Of course, to some extent, the current penetration rates in rural areas reflect the workings of existing subsidy policies. The point of targeting, however, is that the costs of these programs could be reduced while at the same time increasing their effectiveness in *rural*, as well as urban, areas.

Universal service policies that target subsidies to particular states based on their "rural" nature, rather than the income level or socioeconomic conditions of the individual, are likely to waste money and accomplish little in terms of the social goals of universal service.

The second step in reforming untargeted disbursement is to base the subsidies from which a household benefits on characteristics that determine that household's needs for them. As the *Monitoring Report* makes clear, the Commission has the data needed to identify which groups are those in need of subsidies. And the successful operation of Lifeline and LinkUp programs shows that targeted policies are administratively feasible. Two characteristics that play central roles in today's universal service programs are household income and the costs of providing service in the household's local exchange. Both characteristics could serve as a basis of targeting.

It is important to be clear about the role that the costs of providing service would play in a properly targeted policy. Under current policies, all households in a high-cost area who subscribe to their incumbent LEC receive subsidized service. But even in high-cost areas, not all households need or deserve subsidies. As the pattern of penetration rates documented in the Commission's *Monitoring Report* makes clear, a high-income household in a high-cost area is less in need of a subsidy than is a low-income household in an average cost area. Stated bluntly, a movie star with a ranch in Montana is less in need of assistance than is a minority single mother working at the minimum wage in Chicago. Yet the largest current federal

universal service program would subsidize the movie star's telephone service, and not the working mother's.

Appropriate targeting and can, and should, be accomplished by making the subsidy that a household receives depend on *both* the household's income and the costs of access services in that household's area.<sup>23</sup> Thus, if two household have the same income levels, but one lives in an area with higher access costs, that household should receive a larger subsidy. At the same time, if two household both live in the same high-cost area, the household with the lower income should receive the larger subsidy.

Ideally, these targeted subsidies would be distributed through a voucher system. A voucher system is an administratively simple (at least in comparison with the alternatives) means of ensuring that the fundamental goal of competitive neutrality is met because consumers are free to patronize that carrier who offers them the best combination of price and service. Moreover, a voucher system provides an administratively workable means to end the wasteful subsidization of second, third, and other additional lines.

## **B. The Funding of Universal Service Programs**

Even if, *arguendo*, universal service funds were efficiently and effectively spent, there are tremendous inefficiencies in the way that telecommunications consumers and providers are

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<sup>23</sup> To some extent, subsidy amounts already vary with these two household characteristics, but for the vast majority of households subsidy levels are not adjusted to reflect income differences.

taxed to raise these funds. Universal service subsidies do not come free. Either implicit or explicit taxes have to be levied on telecommunications service providers and consumers to fund the subsidies. In this case, Congress directed that universal service mechanisms be funded from “equitable and non-discriminatory” contributions from telecommunications carriers, but of course businesses in a competitive market will pass these costs on to their consumers.<sup>24</sup> There are three types of economic costs associated with these taxes.

First, there are the direct costs of the taxes. For every dollar of subsidy granted to one firm or household, a dollar has to be taken away from another. Second, there are the administrative costs of collecting and dispersing the taxes and subsidies. Inevitably, a third type of costs arise as well: the imposition of a tax distorts providers’ investment and supply decisions and subscribers’ consumption decisions, and thus gives rise to efficiency losses. These efficiency costs are *in addition* to the direct losses of income that consumers suffer from bearing the tax burdens. These efficiency costs are referred to by economists as the *deadweight loss* of taxation because they represent costs for which there is no offsetting benefit.<sup>25</sup>

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<sup>24</sup> Of course, in the monopoly environment to which regulators are accustomed and in which many incumbent LECs still operate, Congress and the Commission could restrict or direct how consumers would eventually bear these costs.

<sup>25</sup> In contrast, the taking a dollar from one subscriber and giving it to another is referred to as a *pure transfer* because there is a dollar benefit to the recipient that offsets the dollar cost to the other consumer.

Two important policy conclusions follow from the existence of deadweight losses. First, the efficiency costs above and beyond the resources spent directly providing services should be taken into consideration when choosing whether to expand federal universal service programs and trigger additional costs. Second, universal service policy should be designed to minimize the pure waste that deadweight losses represent.

As AirTouch has demonstrated in earlier filings, universal service taxation policies generate *billions* of dollars of deadweight loss per year.<sup>26</sup> That is, Commission universal service policies burden the economy by billions of dollars per year above and beyond the actual costs of the programs themselves. AirTouch is not alone in concluding that policies put in place in the name of universal service waste billions of dollars annually. For example, economists Robert Crandall and Leonard Waverman calculated that rebalancing residential local, business local, and long distance prices to conform more closely with economic principles would result in an annual welfare gain of \$8 billion for the U.S. as a whole.<sup>27</sup> Current policies harm consumers and suppress demand for the toll and wireless telecommunications services whose revenues are used to subsidize local service.

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<sup>26</sup> See "Comments on Universal Service Recommended Decision of AirTouch Communications, Inc.," in the matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, filed December 19, 1996.

<sup>27</sup> Robert W. Crandall and Leonard Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications*. Washington, D.C.: The Brookings Institution, 1995, at 93.

The fundamental problem with current policies is that they tax long distance and wireless telephone services in order to subsidize many subscribers' local exchange services. Many consumers are simply paying a tax on one service to receive a subsidy on another. The effect of this system of taxes and subsidies is to create tremendous economic distortions with little benefit. Studies of consumer demand consistently show that raising the rates of long distance and wireless services significantly suppress demand for those services.<sup>28</sup> Even where the cost of the existing usage-based universal service subsidies do not result in disconnections, they work contrary to universal service policy goals by deterring the usage of telecommunications services, particularly advanced services such as wireless.

Empirical studies have also shown that the resulting increases in long distance prices lower the incentives to subscribe to the public switched telephone network by an amount that almost completely offsets any increase in subscription incentives due to lower prices for basic local exchange services. The result is that existing policies may actually lead to disconnections, particularly for the urban poor. For example, a Rutgers University study found that the primary reason for most disconnections was the inability to pay high charges for long-distance toll calls and optional features<sup>29</sup>—the very services being used to subsidize

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<sup>28</sup> Many of these studies are summarized in Lester Taylor, *Telecommunications Demand in Theory and Practice*, Dordrecht: Kluwer Academic Publishers, 1994.

<sup>29</sup> See Milton Mueller and Jorge Schement, "Six Myths of Telephone Penetration: Universal Service From the Bottom Up," Rutgers University Project on Information Policy (1994) at 9. See also Hausman, Tardiff, and Alexander Belinfante, 1993.

access to telecommunications. The net effect of universal service tax and subsidy policy is actually harmful to universal service.

### **III. DEFINITIONS AND INTERPRETATIONS**

As directed by questions (1) and (2) of the appropriations legislation, the Commission must report on its interpretations of a number of definitions. In several important instances, the Commission has failed to apply definitions consistently and in a manner that would promote the fair and efficient operation of universal service policies.

Questions concerning definitions touch on the two fundamental issues of universal service policy design: (a) Which consumers and carriers, and which services, are eligible for support? and (b) Which consumers and carriers have to bear the costs of universal service programs? These issues are addressed in Sections IV and V below. In the present section, we make several general comments about definitions.

The Commission has run into a variety of problems attempting to define "information service," "local exchange carrier," "telecommunications," "telecommunications service," "telecommunications carrier," and "telephone exchange service." The reason for these

difficulties is that many of the distinctions are arbitrary.<sup>30</sup> In the light of the fact that the Commission bases substantive policies on these arbitrary definitions, it should come as no surprise that carriers attempt to take advantage of the inherent ambiguities in the definitions.

Unfortunately, the problem of arbitrary definitional distinctions is not limited to universal service policy. Similar problems arise in the context of interconnection and access charge policies, for instance. One of the most striking examples is that some ISPs avoid paying for their use of the public switched network through the use of Commission-created loopholes and at the same time claim that they should be eligible to collect fees for providing transport and termination to local exchange carriers.<sup>31</sup>

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<sup>30</sup> Perhaps the most salient example is the distinction between “telecommunications” and “information services.” See, e.g., 47 U.S.C. §§ 153(20), 153(43). This distinction that has proved over the years to be extraordinarily difficult to administer. See, e.g., *Universal Service Order*, para. 789; see also *Second Computer Inquiry*, 77 F.C.C. 2d. 384, aff’d sub. nom. Computer and Communications Industry Ass’n v. FCC, 693 F.2d 198 (D.C. Cir., 1982), cert. denied, 461 U.S. 938 (1983). Other administrative issues have arisen between the definitions of “telephone exchange service” and “telephone toll service,” particularly in the wireless context where the historical understanding behind these distinctions is inapplicable. See, e.g. Petition for Reconsideration of AirTouch Communications, CC Docket 96-61, (October 2, 1997)(noting that CMRS traffic cannot easily be classified relative to the same “exchange boundaries” used in the wireline network).

<sup>31</sup> Compare *Universal Service Order*, para. 789-90; “Implementation of the Local Competition Provisions,” CC Docket No. 96-98, *First Report and Order* 11 FCC Rcd 15499 (1996)(*Local Competition Order*) at para. 992, aff’d in part and vacated in part sub nom. Iowa Utilities Board v. FCC, 120 F.3d 753, 1997 WL 403401 (8<sup>th</sup> Cir. 1997)(*Iowa Utilities Board*).

#### IV. CONTRIBUTORS TO UNIVERSAL SERVICE

Current and proposed universal service programs cost billions of dollars per year. That means that billions of dollars per year in taxes must be collected to finance these programs. The burden of these taxes is borne by the consumers who purchase the taxed services, as well as by the workers and shareholders of the companies that supply the taxed services.<sup>32</sup> The manner in which the tax burden is shared among the consumers, workers, and shareholders is important for both equity and efficiency. Unfortunately, the Commission has chosen to levy universal service taxes in an inequitable and extremely inefficient manner. The result is needlessly to increase the burden borne by consumers, workers, and shareholders by billions of dollars per year. This is money that is simply wasted as the result of misguided Commission actions.

The best way to finance universal service support would be to fund the programs out of general tax revenues.<sup>33</sup> In that way, the funds collection could be coordinated with other tax programs to ensure that burdens are fairly and efficiently shared among all members of

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<sup>32</sup> Even if a tax is nominally levied on carriers only, it is well-established that the burden of the tax is borne by consumers in addition to the owners and employees of the carriers themselves. For a standard analysis of the effects of excise taxes, see Michael L. Katz and Harvey S. Rosen, *Microeconomics*, 3ed, Boston: Irwin/McGraw Hill, 1998 at 349-357.

<sup>33</sup> This is, in fact, the form of financing used for several universal service programs not administered by the Commission, such as the Rural Utilities Service of the U.S. Department of Agriculture.

society. Moreover, it is a well-established economic principle that broad-based tax collection schemes are less disruptive to economic activity and give rise to smaller social costs.<sup>34</sup>

In a recent study of the schools and libraries program, Professor Jerry Hausman found that for each additional dollar of tax placed on interstate telecommunications services, the additional burden on the economy is \$2.25.<sup>35</sup> The \$1.25 difference between the amount of the tax and harm to the economy is the deadweight loss. The incremental deadweight losses from taxes on interstate telecommunications services are greater than the revenues raised! In contrast, Hausman found that the estimates in the academic literature on the cost of raising a dollar of revenue through the overall federal tax system range from \$1.26 to \$1.41 per dollar raised.<sup>36</sup> Thus, estimates of the deadweight loss associated with use of the overall tax system range from range from \$0.26 to \$0.41—less than one third of the efficiency losses associated with taxes on interstate telecommunications services.

Congress has chosen not to fund universal service out of general tax revenues. Instead, the taxes are to be collected from communications carriers; for most carriers, these costs will be passed on to their customers. But even limited to this tax base, the Commission

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<sup>34</sup> For a summary of the optimal taxation literature, see Anthony B. Atkinson and Joseph E. Stiglitz, *Lectures on Public Economics*. New York: McGraw-Hill, 1980. See also, Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation." In *Handbook of Public Economics Vol. 1*, edited by Alan J. Auerbach and Martin Feldstein. Amsterdam: North Holland, 1985.

<sup>35</sup> See Jerry Hausman, "Taxation by Telecommunications Regulation," National Bureau of Economics Research, Working Paper 6260, November 1997, at 15.

<sup>36</sup> *Id.* at 16.

has wide discretion in how it levies the taxes. As AirTouch has shown in its earlier comments, the Commission has not chosen to collect these telecommunications taxes in ways that would minimize the drag that they place on the economy.<sup>37</sup>

#### **A. The Form of Universal Service Taxes**

The Commission should fund federal universal service programs through a flat end-user surcharge. This basis is superior to all others in terms of fairness, efficiency, and accountability. Adoption of this approach would save telecommunications consumers billions of dollars each year in comparison with taxes on interstate revenues that raise the same amounts of contribution.<sup>38</sup>

The flat surcharge builds on two fundamental ideas. One, an end-user surcharge is administratively workable, accountable, fair, and competitively neutral. Two, the Commission

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<sup>37</sup> As explained in an earlier filing, to be efficient, universal service taxes must adhere to the following principles: (a) have as broad a tax base as possible; (b) rely on lump-sum taxation to the extent feasible; (c) where prices are distorted by the need to raise contribution, the responsiveness of supply and demand to price must be taken into account; (d) don't tax distort production without a good reason; and (e) don't distort competition. The Commission's current and planned universal service policies violate all five principles. *See* "Reply Comments of AirTouch Communications, Inc.," in the matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, filed May 6, 1996 at 6-7. For a quantitative analysis of the losses due to poorly chosen Commission policies, *see* "Comments on Universal Service Recommended Decision of AirTouch Communications, Inc.," in the matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, filed December 19, 1996.

<sup>38</sup> *See* "Reply of AirTouch Communications, Inc. on Federal-State Joint Board Recommended Decision," in the matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, filed January 10, 1997.

should not distort consumption investment decisions by levying traffic-sensitive charges to recover non-traffic-sensitive costs. The California PUC has adopted an end user universal service surcharge, in part because a system that taxes carriers who then pass the costs on to consumers could cause implicit subsidies to continue, as carriers will “undoubtedly try to raise the rates that currently support below cost rates in high cost areas.”<sup>39</sup>

A flat surcharge is equitable because all telephone subscribers contribute equally. Of course, actual end users vary, and in theory policy makers might wish to vary levels of contribution across end users. But on what basis should contributions vary? Using the notion of ability to pay, subscriber income level might be the most logical choice. Such variation could readily be incorporated into a flat end-user surcharge: residential end users below a defined income level would not pay the contribution (indeed they would be eligible for universal service subsidies), while end users above the threshold would pay the fixed monthly contribution. By piggybacking on the existing criterion used to assess eligibility for subsidies

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<sup>39</sup> California Public Utilities Commission, D.96-10-066 (October 26, 1996), at 184. Of course, as discussed below, this is precisely what the Commission’s policies have done by allowing LECs to recover the costs of their contributions in access charges.

Lifeline and Linkup programs, this approach would not create additional administrative burdens.<sup>40</sup> It is thus a low-cost way to account differences in ability to pay.

This approach is clearly superior to the Commission's chosen approach of taxing service revenues. Some might argue that people who pay a lot for telephone service must be relatively wealthy and thus have the ability to contribute more to funding universal service. In practice, however, the link between subscriber income and monthly bills is a weak one. Moreover, high payments for telephone services may reflect high prices, rather than high volumes. While high volumes may be associated with greater net consumer benefits, high prices typically are associated with low consumer benefits. Thus, the size of subscriber's bill (or the size of carrier revenues) is a poor way to tie subscribers' contribution burdens to some notion of how much they "deserve" to pay.

It is a well-established principle of public finance economics, that policy makers should rely on lump-sum taxation to the extent feasible. A pure lump-sum tax (or one that depends on tax payer characteristics that are beyond his or her control) is efficient because the person on whom it is levied can do nothing to affect the amount, and thus there is no incentive for the

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<sup>40</sup> See 47 C.F.R. §§ 54.400, *et seq.* While 54.407 provides for carriers to obtain reimbursement for providing Lifeline services, the administrative procedures for distributing support in this manner are far too complex. A simpler measure would be simply to set the surcharge amount at a level that is high enough to cover program costs through assessment on only the non-low-income end users, and integrate the end user surcharge with the Lifeline program. There is absolutely no policy reason to link the Lifeline program to the federal Subscriber Line Charge ("SLC") or the \$3.50 current amount of the SLC.